REPORT BY THE
AUDITOR GENERAL
OF CALIFORNIA

A REVIEW OF THE USEFULNESS OF DOMESTIC DISCLOSURE SPREADSHEETS TO THE FRANCHISE TAX BOARD

F-864 **DECEMBER 1991**

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December 19, 1991 F-864

Honorable Robert J. Campbell, Chairman
Members, Joint Legislative Audit Committee
State Capitol, Room 2163
Sacramento, California 95814

Dear Mr. Chairman and Members:

Summary

In 1988, Section 25401d was added to the Revenue and Taxation Code. This section amends the filing requirements for multinational banks and corporations (hereafter referred to as corporations) regarding the preparation of Domestic Disclosure Spreadsheets (spreadsheets). The spreadsheets disclose to the Franchise Tax Board (FTB) financial information on the corporations' and their affiliates' operations in each state. The FTB plans to use this information to ensure compliance with California tax laws. Section 25401d(g) requires the Office of the Auditor General to review the usefulness of the spreadsheets to the FTB audits and to submit a preliminary report of its findings to the Legislature by December 31, 1991, and a final report by December 31, 1994. We found that the FTB has only recently trained its auditors to use the spreadsheets and that they have only reviewed a small percentage of the spreadsheets corporations have filed. Thus, it is too early to make a definitive conclusion about the usefulness of the spreadsheets to the FTB's audits. Nonetheless, the preliminary responses from the FTB's auditors indicate that while some auditors did express positive comments about the potential benefits of parts of the spreadsheets, some of the other auditors did conclude the

spreadsheets were unnecessary. We also found the FTB has assessed penalties of approximately $1.8 million against corporations that failed to file, filed late, or filed incomplete spreadsheets. Finally, we found the FTB has contacted the Internal Revenue Service and the Multistate Tax Commission about providing both agencies with information from the spreadsheets to enhance these agencies' abilities to ensure taxpayer compliance.

Background

Senate Bill 85, which became Chapter 989, Statutes of 1988, amended the statutes related to taxpayer responsibilities for making the "water's-edge election" under the unitary tax method. The unitary method is a system of assessing income tax on multinational or domestic corporations having part of their operations in California. The water's-edge election generally allows a multinational corporation to exclude foreign affiliates in determining a corporation's California taxable income.

Unitary Tax Method

California's unitary tax method, when applied to a multinational corporation, is a system of determining for California income tax purposes how much of a multinational corporation's worldwide income is attributable to California. Three factors are considered when determining a multinational corporation's unitary tax:

1. The corporation's California sales compared with its worldwide sales;
2. The corporation's property held in California compared with its property held worldwide; and
3. The corporation's payroll in California compared with its payroll worldwide.

For example, if a corporation had total worldwide sales of $50 million and $20 million of these sales occurred in California, then it would apportion 20/50 of its worldwide sales to California. The corporation would follow the same process for property and payroll. The corporation averages these three fractions, converted into percentages, to determine the proportion of its worldwide income that is subject to California income tax.

Water's-Edge Election

The water's-edge election is a contract between a multinational corporation and the FTB that modifies the unitary tax method. The election results in generally excluding foreign affiliates in determining a corporation's California taxable income. The contract is for an initial five-year period.

After making the water's-edge election, a corporation, within six months of filing a California tax return, must file a spreadsheet detailing specific financial information if it meets either of two tests:

1. Total assets test—if the total assets (original cost net of depreciation) of the corporation and its affiliates exceed $250 million; or

2. Foreign factor test—if the total property, payroll, or sales in foreign countries for the affiliated group exceed $10 million.

The corporation must file a spreadsheet once every three years after the election unless the filing year is an income year in which the corporation has less than $500,000 each in property, payroll, and sales in the United States.

Domestic Disclosure Spreadsheets

According to an official of the FTB, the concept of the spreadsheet developed from discussions held under the sponsorship of the Worldwide Unitary Taxation Working Group (working group). This working group included representatives of the federal government, state governments, and the national and international business community. Established under the administration of President Reagan, the working group was designed to develop possible alternatives to the states using the worldwide unitary method of taxation. According to an FTB official who provided technical assistance to the working group, the business community accepted the spreadsheet concept as a tool to partially address the compliance concerns of the states in exchange for the states addressing concerns of the business community about the worldwide unitary method of taxation.

The spreadsheet is a six-part form designed to provide the FTB with financial information on corporations that have made the water's-edge election. The FTB plans to use this financial information to ensure compliance with California tax laws. The first part of the spreadsheet is a listing of affiliated companies. The FTB auditors can compare this listing with the California corporate tax return to ensure that all the required companies were included in the corporation's combined report. A combined report is not a tax return, but is a combination of seven worksheets the corporation uses to combine its financial activities and those of its affiliates to determine the amount of income properly attributable to California sources. The listing may also be useful in identifying transactions with related parties.

The second part of the spreadsheet is a schedule of state income and tax liabilities of all states where the corporation or an affiliate has a liability. The third part is a form that shows all states in which the corporation or an affiliate has filed a tax return on a consolidated or combined basis.

The fourth part shows the apportionment percentages used by the corporation and its affiliates in all state tax filings. The corporation shows the apportionment percentages for property,

payroll, and sales for each state tax filing. For each line item, the corporation shows the percentage of its property, payroll, and sales located in each state compared with its total property, payroll, and sales.

The fifth part of the spreadsheet is a schedule of nonbusiness income or loss. The precise definition of nonbusiness income may vary from state to state. For example, in California, if a manufacturing corporation owned an office building as an investment and did not occupy part of the building, the net rental income would be nonbusiness income.

The sixth part of the spreadsheet is a list of destination sales. In California, these sales are defined as tangible personal property produced in one state but sold in another state. This section of the spreadsheet shows destination sales for every affiliate, state by state, and whether the sales in these states are taxable by the destination state. For example, a corporation that produces goods in another state but sells them in California would, in certain instances, use California as the state where the destination sales occurred.

Scope and Methodology

To determine the usefulness of the spreadsheets, we interviewed FTB officials and employees and reviewed FTB records and documents related to the spreadsheets. We also analyzed the results of an FTB questionnaire distributed to field auditors who had used the spreadsheets to plan or perform an audit. Finally, we conducted our own phone survey of the FTB auditors who have used the spreadsheets.

Current Uses of the Spreadsheet

The requirement to file the spreadsheets is a relatively recent addition to the California Revenue and Taxation Code, and the FTB auditors have identified limited benefits from using them. Also, the FTB only recently completed training 41 auditors to use the spreadsheets, and only 15 of these auditors have used them.

Three of the 15 auditors account for more than half of the reviews conducted. Additionally, the spreadsheet reviews that have occurred represent only about 15 percent of the spreadsheets that the FTB has already received and that it expects corporations to submit.

To obtain information about the usefulness of the spreadsheets, the FTB requested that each auditor who had used a spreadsheet to plan or perform an audit complete a questionnaire. We conducted a phone survey of all 15 of those auditors. The answers to the FTB's questionnaire and our phone survey resulted in similar conclusions. Specifically, an FTB official believes it is too early to even tentatively conclude on the usefulness of the spreadsheets. Notwithstanding this belief, the FTB's auditors did cite examples where information provided on the spreadsheets has the potential to be beneficial. Most of the auditors who described some part of the spreadsheet as useful mentioned the first part, the schedule of affiliated corporations. In some cases, this information is available from other sources. However, according to one of the auditors in our survey, if the taxpayer is a small or private corporation, then the spreadsheet may be the only source of the information unless the auditors specifically request it from the taxpayer. Thus, having the spreadsheet information readily available saves the auditors time.

In addition, the auditors may be able to identify potential audit issues related to corporations for which field audits were not planned. An FTB auditor identified an instance when the information on the spreadsheet raised a potential audit issue. Specifically, by reviewing the spreadsheet, the auditor identified two affiliated corporations that may have been mistakenly omitted from the corporation's California tax return.

Some of the auditors also concluded that the fourth part of the spreadsheet, the schedule of apportionment percentages, might be useful. The apportionment schedule provides the dollar value of property, payroll, and sales in other states. The apportionment listing can also highlight inconsistencies in the state filings. For example, an FTB auditor found the apportionment schedule in the spreadsheet helpful because it appeared that only 37 percent of a

corporation's total payroll was apportioned among various states. Since 100 percent of the corporation's payroll should potentially be accounted for on the spreadsheet, the auditor viewed this variation as a potential audit issue that might require an explanation from the corporation.

Based on the comments of the auditors who responded to the FTB's questionnaire and our phone survey, most of the auditors had not yet used all parts of the spreadsheets. Thus, we concur with the FTB official who concluded that the spreadsheets are too new to make any meaningful conclusions about their usefulness. However, despite the newness of the spreadsheets and the positive comments we mention above, some auditors did not see any benefit from requiring corporations to provide this information since the auditors believe they could easily request similar information from the corporations if necessary.

Penalties

Penalties are important for ensuring corporations file a timely and complete spreadsheet. The FTB has developed procedures to supplement the statutes and regulations concerning penalties for corporations who do not file, file late, or file incomplete spreadsheets. Although the spreadsheet filing requirements are a relatively recent addition to the tax code, the FTB has achieved a compliance rate of 93 percent. One of the reasons that the FTB has achieved this rate is that it assesses substantial penalties for noncompliance. As of September 24, 1991, the FTB has assessed penalties of $1,846,000. Although we did not determine the portion of this amount that has been collected, we did determine that $715,000 of these penalties are being protested by the corporations.

Future Uses of the California Spreadsheets by Others

The FTB has had preliminary contacts with two agencies regarding potential uses of the spreadsheets. The FTB contacted the Internal Revenue Service (IRS) and offered to provide information if the IRS deemed it useful. IRS personnel have also attended the FTB's water's-edge election training, which included reviews outlining

uses of the spreadsheets. However, as of September 1991, the IRS has not made any formal requests for information from the FTB.

The FTB has also been in contact with the Multistate Tax Commission (MTC). The MTC is the only statutory interstate tax agency in the nation. The heads of 31 state tax agencies and of the District of Columbia are members or associate members of the MTC. Full members are from states that have incorporated the Multistate Tax Compact (compact) into their tax code. The main purpose of the MTC is to administer the compact. The compact is a model for taxation of corporations with multistate operations. One current project of the MTC is the Nexus program. The purpose of the program is to develop a forum where participating states, not only those in the MTC, could share the property, payroll, and sales apportionment data of multistate corporations. This is the same data that California requires on the fourth part of the spreadsheet. The MTC believes sharing data among the participating states will promote increased tax compliance of multistate corporations. For the MTC to evaluate the potential of the spreadsheets, the FTB has provided copies of ten spreadsheets to the Nexus program committee chairman. After the committee reviews the spreadsheets, it will decide if they will be of any use to the Nexus program. If the committee concludes that obtaining this information is beneficial, the FTB plans to develop a system to provide the information to the MTC.

We conducted this review under the authority vested in the auditor general by Section 10500 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this letter report.

Respectfully submitted,

Kurt R. Sjoberg

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Response to the Audit

State and Consumer Services Agency

PETE WILSON
GOVERNOR

State and Consumer Services Agency

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Building Standards Commission
Consumer Affairs
Fair Employment & Housing
Fire Marshal
Franchise Tax Board
General Services
Museum of Science & Industry
Personnel Board
Public Employees' Retirement System
Teachers' Retirement System
Veterans Affairs

December 3, 1991

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Acting Auditor General
660 J Street, Suite 300
Sacramento, Ca 95814

RE: RESPONSE TO AUDITOR GENERAL LETTER NO. F-864

Dear Mr. Sjoberg:

Thank you for the opportunity to respond to your Letter Report F-864 entitled "Domestic Disclosure Spreadsheets." The State and Consumer Services Agency and the Franchise Tax Board agree with your comment that it is too early to make a definitive conclusion about the usefulness of the spreadsheets to the Franchise Tax Board's audits.

The Franchise Tax Board has suggested some technical wording revisions with respect to referencing corporations and their affiliates on page 1, Summary; page 2, first and last paragraph; page 3, first paragraph and page 4, second paragraph. All suggestions are based on the specific terminology of the statute. *

If you need further information or assistance on this issue, you may wish to have your staff contact Gerald H. Goldberg, Executive Officer, Franchise Tax Board, at 369-4543.

Best regards,

Barbara Filger
for BONNIE GUITON
Secretary of the Agency

cc: Gerald H. Goldberg, Executive Officer, Franchise Tax Board

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***The Office of the Auditor General's comment: We made technical wording changes when we deemed appropriate.**

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps